IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. ——.

SUFFOLK SECURITIES CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION.

OPINION BELOW.

The opinion of the Circuit Court of Appeals for the Second Circuit is officially reported at 128 Fed. (2nd) 743 and is printed in the Record (p. 151).

JURISDICTION.

The judgment of the United States Circuit Court of Appeals was entered on July 6, 1942. A petition for rehearing was overruled on September 12, 1942. The jurisdiction of this Court is invoked under Section 240-a of the Judicial Code, as amended by the Act of February 3, 1925.

QUESTIONS PRESENTED.

Questions presented are indicated in the Petition (*ante*, p. 2).

STATUTES INVOLVED.

The statutes are indicated in the Petition (*ante*, p.) and printed in the Appendix (pp. 17-18).

STATEMENT.

A statement of the facts involved is contained in the Petition (*ante*, pp. 2-3).

SPECIFICATION OF ERRORS.

The Specification of Errors to be urged are indicated in the Petition (*ante*, p. 5).

ARGUMENT.

I.

The evidence did not support the ultimate conclusion and decision of the Board of Tax Appeals.

The decision of the Board of Tax Appeals results in the Petitioner paying a 50 per cent tax on $113,087.92, with interest from January 15, 1930, on the theory that it allowed its gains and profits to accumulate for the purpose of preventing the imposition of surtaxes upon its stockholder. Under the decision the Petitioner was obligated to distribute $113,087.92 as a dividend to its stockholder, all of which would not have been subject to surtaxes in the stockholder's personal returns. The uncontradicted evidence in the Record shows that the Petitioner had no accumulated gains and profits or surplus in the taxable year 1930 in the amount of $113,087.92 and had a deficit for each year since its organization except at the end of the year 1930, when it had a book surplus of $72,947.03 and statutory net losses for the years 1929 and 1930 of $1,199.50 and $78,109.87, respectively (Joint Exhibits 9-C and 10-D, R. 114-115).

In order to properly show the gains and profits for the taxable year, the book surplus should have been reduced by the expenses for the year, including the Federal taxes, and interest due, paid or accrued, which in this case would have eliminated the book surplus.

Earnings and profits are computed by deducting from gross receipts the expenses of producing them (*Mobile & Ohio Ry.* v. *Tennessee,* 153 N. S. 486-497). In this classification may be listed such items as extraordinary expenses, charitable contributions, taxes paid the Federal Government, and taxes assessed against local benefits (*R. M. Weyerhaeuser,* 33 B. T. A. 594-597), and cases cited.

The assets of the petition were carried in its book and balance sheets at cost and on November 30, 1930 the then market value was $1,585,700.74 less than cost (R. 82). If the then *market* value had been used in the balance sheets instead of cost, there would have been a deficit of over $1,000,000. Whether a corporation is solvent and has surplus or net profits out of which dividends may be paid must be determined on the basis of the then actual cost or fair market value of its assets.

Mobile & Ohio Ry. Co. v. *Tennessee,* 153 N. S. 86; *Whitaker* v. *Amwell National Bank,* 52 N. J. eq. 400, 29 Atl. 203; *American Steel & Wire Co.* v. *Eddy,* 138 Mich. 403, 101 N. W. 578; *Siegman* v. *Electric Vehicle Co.,* 140 Fed. 117; *Cannon* v. *Wiscassett Mills Co.,* 195 N. C. 119, 141 S. E. 344.

In the case of *W. S. Farish & Co.* v. *Commissioner,* 38 B. T. A. 150 Aff'd 104 Fed. (2nd) 833, the Board said:

> "Application of the statute obviously depends upon the existence of 'gains and profits' which have been accumulated (instead of being divided or distributed) for the purpose of preventing the imposition of tax upon the shareholders. If petitioner corporation had no accumulated gains or profits to be divided or distributed in the taxable year, it could not have been availed of for the proscribed purpose."

Therefore, under no theory could the Petitioner have distributed to its stockholder as dividends any amount in excess of $72,947.03, nor did the stockholder have to report any larger amount in its personal returns under Section 104(d) to be relieved of the 50 per cent tax (Appendix, pp. 17-18). Any amount distributed in excess of the surplus would have been a distribution from capital and would not be taxable income to the stockholder. It is well settled that a distribution by a corporation to its stockholders out of its capital and not out of gains and profits accumulated since February 28, 1913 are not taxable income to the recipients (*Foley Securities Corporation* v. *Commissioner,* 106 F. (2d) 731; *Helvering* v. *Jarvis,* 123 F. (2d) 742; *Reinstrom* v. *Commissioner,* 125 F. (2d) 790; *Patty* v. *Helvering,* 98 F. (2d) 717). Therefore, the Petitioner could not have been availed of to prevent the imposition of surtaxes on any amount in excess of its earnings or profits.

The Commissioner determined that the Petitioner had no net income for the year 1930 but a net loss of $47,674.60 and no tax due under Section 13 (Deficiency Letter, R. 16).

Section 104(a) provides for a tax of 50 per cent of the *net income,* which shall be in addition to the tax imposed by Section 13. In Section 104(c) the term "net income" is defined as the net income as defined by Section 21 increased by the amount of dividends allowed under Section 23 (p) (Appendix, pp. 17-18). Section 21 defines "net income" as the gross income computed under Section 22 less the deductions allowed by Section 23.

There is a distinct difference between net income and gains and profits. Taxable net income is purely a statutory concept and bears no necessary relation to gains and profits subject to distribution as dividends (*W. S. Farish & Co.,* 38 B. T. A. 150; *Ida C. McKinney,* 32 B. T. A. 450).

Gains and profits mean the stockholder's share of the corporation's gains and profits for the year, i.e., that portion which a corporation might properly distribute to its stockholders as dividends. The Revenue Acts impose taxes

on statutory net income. It is contended that a corporation which had no statutory net income under Section 21 in a taxable year would not be subject to taxes under Section 104. Even though Section 104(c) provides that the net income shall be increased by the amount of dividends, there would have to be a net income before it could be increased by the dividends. This question has not been passed on by the Board or any of the courts and it is doubtful that it was ever raised, as in most of the cases heretofore decided where Section 104 was attempted to be applied, the corporation had statutory net income in the taxable year and paid taxes under Section 13 or similar Sections of the Revenue Acts.

In *A. D. Sanger, Inc.* v. *Commissioner* (84 F. (2d) 23-24), the Court said:

> "Of course, if the corporation fails to have gains and profits to the extent that there is no net income, the tax fails."

The Board held that the Petitioner was a mere holding or investment company which raised the presumption that it was availed of to prevent the imposition of surtax on its stockholder, which presumption was not disproved by petitioner evidence (R. 29). The Board did not find as a fact that the corporation had allowed its gains and profits to accumulate beyond its reasonable needs.

Therefore, there would be no presumption under that part of the Section that the Petitioner was availed of for the prohibited purpose. Whether the Petitioner was a *mere* holding or investment company is a question of law or a question of mixed law and fact. Petitioner has heretofore contended that it was not a mere holding or investment company but was formed and operated for the purpose of the liquidation of the partnership and it was unable to liquidate before the taxable year because of its inability to dispose of its assets to pay its creditors in full and the return of its capital to its stockholder.

One of its large assets, the United States Government claim, was not finally liquidated until 1932. (R. 90) Another of its large assets, the Dominican Sugar Company, was not disposed of until 1931 at a loss of over a million dollars (R. 104), and some of its largest notes and debts payable were secured by its assets, to liquidate which would have imperiled the security of the loan to its creditors. It is contended that the Petitioner was not a *mere* holding or investment company and there was no presumption that it was availed of for the proscribed purpose (*Flint* v. *Tracy Co.*, 220 U. S. 107-171; *Chicago Stockyards Company* v. *Commissioner*, reversing B. T. A., 129 Fed. (2d) 937. Certiorari granted Dec. 7, 1942; *United States Industrial Bankers Securities Corporation* v. *Higgins*, 104 F. (2d) 177; *Chevrolet Motor Company* v. *United States*, 64 Ct. Cl. 211, Certiorari Denied, 277 U. S. 585).

Even if there was a presumption to rebut, it is submitted that a consideration of all the evidence in the case with the proper inferences to be drawn therefrom, would show the lack of intent or purpose to evade surtaxes.

The ultimate finding by the Board of Tax Appeals that the Petitioner was availed of for the purpose of preventing the imposition of surtaxes on its stockholder is a question of law or a determination of mixed law and fact, based on the Board's findings of primary, evidentiary or circumstantial facts, is subject to judicial review and on such review the Court may substitute its judgment for that of the Board (*Helvering* v. *Tex-Penn Company*, 300 U. S. 481; *Farmer* v. *Commissioner*, 126 F. (2d) 542; *United States* v. *State Street Trust Company*, 124 F. (2d) 948; *Chicago Stockyards, supra*).

In the case of *Helvering* v. *Tex-Penn Company*, the Court said:

> "The ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary or circumstantial facts. It is sub-

ject to judicial review and, on such review, the court may substitute its judgment for that of the Board. Helvering v. Rankin, 295 U. S. 123."

If the Board's findings of primary, evidentiary or circumstantial facts is erroneous, then the findings would not support the ultimate finding. In the Board's Opinion (R. 30), it indicates that because the Petitioner's assets exceeded its liabilities and it was not insolvent, that it was obligated to declare dividends or make distribution to its stockholder, on which finding, no doubt, the Board based its ultimate finding. This assumption is clearly erroneous, as it is well established that in considering whether a corporation has accumulated gains and profits out of which to declare dividends, the capital stock should be taken into consideration (*Willcutts* v. *Milton Dairy Company,* 275 U. S. 215; *Helvering* v. *Canfield,* 281 U. S. 163; *Mobile & Ohio Ry. Co.* v. *Tennessee,* 153 U. S. 486). It is difficult to determine upon which primary or evidentiary facts the Board based its ultimate finding. The evidence shows that the book surplus was not large in comparison with a corporation with assets of a book value of over $5,000,000 and capital stock outstanding of over $4,000,000 and which had net losses for the year. The additional tax that the sole stockholder of Petitioner would have been liable for had the book surplus of $72,947.03 been distributed to him, would have amounted to less than $15,000, or the stockholder could have reported the amount of the book surplus without it being distributed to him, in his personal return, and it would have only increased his personal taxes by less than $15,000. The petition reported $817,055.85 as dividends received from domestic corporations from 1923 to 1930. James H. Post, petitioner's stockholder, reported in his personal returns dividends of $1,008,952.39 for the years 1926 to 1930 (R. 22). Those facts, when balanced against the fact that at the time the Commissioner made his determination of a deficiency on January 15, 1936 of $56,543.96 plus interest at 6 per cent for six years and two months, which would mean a deficiency

of 88 per cent on the constructed net income of $113,087.92, are repugnant to the existence of a purpose or intent to evade surtaxes (*U. S.* v. *T'way Coal Sales Co.*, 75 F. (2d) 336-337; *Chicago Stockyards Co.* v. *Commissioner, supra*).

In the case of *Estate of James H. Post, deceased, et al.*, v. *Commissioner*, Docket No. 83921, Memorandum Opinion decided April 26, 1939, involving the year 1932, the Board had under consideration the question of the method of accounting employed by Mr. Post in filing his individual returns and the amount of deductions allowable for contributions. In considering this case, the Board went thoroughly into Mr. Post's transactions, including his transactions with the Suffolk Securities Corporation, B. H. Howell Son & Co., Inc., for the years 1922 to 1933, and his income and deductions for the year 1932. The Board held that his accounts had been kept on the accrual basis and that he was limited in the deduction of his contributions to charity. On page 16 of the Board's opinion, it stated:

> "The record shows that James H. Post was a very wealthy man and a philanthropist, very generous in his contributions to public charities. There is nothing in the record indicating that his business transactions involved in this proceeding *were otherwise than bona fide or that the methods of keeping his books and making his income tax returns ever were for the purpose or with a view to evading payment of income tax.* His bookkeeper and confidential secretary, Frank W. Valentine, who was also secretary of B. H. Howell Son & Co., Inc., and Suffolk Securities Corporation, was familiar with the business and accounting methods and transactions of both corporations and had charge of their offices and the preparation of their income tax returns. He also prepared the income tax returns of James H. Post and wife, Louisa Wells Post, for 1932 and prior years. The bookkeeping method or system which he used in 1932 was the same he had used for many years and was used by him in keeping the books and preparing the returns of both aforesaid corporations and of James H. Post and wife." (Italics supplied).

II.

The taxes as assessed are violative of the Fifth and Tenth Amendments to the Constitution.

The taxes imposed in this case are in fact a penalty and are more than those imposed for fraud under the 1928 Act. The penalty for fraud is 50 per cent of the tax, whereas the penalty under Section 104 is 50 per cent of the net income, including dividends, plus interest, a much more severe penalty than for a fraud (*Child Labor Tax Case*, 259 U. S. 34; *Hill* v. *Wallace*, 259 U. S. 44; *Carter* v. *Carter Coal Co.*, 298 U. S. 238; *Lipke* v. *Lederer*, 259 U. S. 557).

The taxes assessed in the instant case are so unreasonable, burdensome, and confiscatory that they are in violation of the Fifth Amendment to the Constitution (*Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1; *Barclay & Co.* v. *Edwards*, 267 U. S. 442; *Nichols* v. *Coolidge*, 275 U. S. 531).

Sections 34 and 35 of the General Corporation Laws of Delaware prohibited the Petitioner from declaring a dividend to its stockholder on the condition of its assets, liabilities and surplus at the end of the year 1930 (Appendix, Page 17) (*Vogtman* v. *Michaels Mortgage and Credit Company*, Delaware Chancery Reports, Vol. 20, Page 364; *Randall as Trustee of Bush Terminal Company* v. *Bailey, et al.*, 23 N. Y. S. (2d) 173).

The power to regulate corporations as to their creation, operation and relations with their directors and stockholders is strictly reserved to the States by the Tenth Amendment and the Federal Government cannot interfere with that power. It may be true that Section 104 ordinarily does not limit the powers of the corporation or the State to control it, as was held in *Helvering* v. *National Grocery Company*, 304 U. S. 282-286. However, the assessment of the penalty tax in this case certainly penalizes the corporation for not doing that which it was prohibited from doing by the State, especially as to any distribution in excess of its earnings and profits, and would conflict with or amount

to a limitation on the power of the State (*Child Labor Tax Case, supra; United States* v. *Jin Fuey Moy,* 241 U. S. 394).

Chief Justice Taft said in the *Child Labor Tax Case:*

> "There comes a time in the extension of the penalizing feature of the so-called tax when it loses its character as such and becomes a mere penalty, with the characteristics of regulation and punishment."

CONCLUSION.

For the foregoing reasons it is respectfully urged that this petition for a writ of certiorari should be granted.

Respectfully submitted,

David A. Buckley

DAVID A. BUCKLEY, JR.,
Attorney for Petitioner.

LORING M. BLACK,
HARVEY L. RABBITT,
Of Counsel.

APPENDIX.

Laws of Delaware 1929

Chapter 135—Domestic Corporations

1948 Section 34 Dividends; Reserves

The Directors of a Corporation shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14-26-27-28 of this chapter, or (b) in case there shall be no such excess out of its net profits for the fiscal year, then current and/or preceding fiscal years, and provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired.

STATUTES INVOLVED.

Revenue Act of 1928; 45 Stat. ch. 852, page 791:

"Sec. 104. Accumulation of Surplus to Evade Surtaxes.

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for

each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

"(c) As used in this section the term 'net income' means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

"(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included."

"SEC. 115, DISTRIBUTIONS BY CORPORATIONS

"(a) Definition of dividend.—The term 'dividend' when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913."